

Internal Revenue Service
memorandum

CC:TL-N-7433-90
Br1:JLRood

date: JUL 20 1990

to: Assistant District Counsel, Indianapolis CC:IND
Attn: STHittinger

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED] v. Commissioner, T.C. Docket No. [REDACTED]

This is in response to your request for tax litigation advice dated June 1, 1990.

ISSUE

Whether the petitioners may deduct the costs incurred to purchase a [REDACTED] distributorship pyramid that are allocable to the distribution rights. 0167-1300.

CONCLUSION

Any portion of the purchase price that is allocable to distribution rights is nonamortizable goodwill because it represents the customer structure of the acquired business. However, an acceptable settlement position would be one in which at least one half of the amount allocated to the distribution rights would be reallocated to nonamortizable goodwill.

FACTS

On [REDACTED], petitioners purchased a [REDACTED] distributorship located in California. At all pertinent times, the petitioners were residents of Indiana.

The [REDACTED] is a direct sales organization which sells merchandise through distributors. The distribution system is a pyramid. The first distributor recruits secondary distributors, who in turn recruit another layer of distributors.

09317

Distributors at all levels can purchase [redacted] products for resale from the [redacted]. A distributor receives income not only from his resale activities, but also from the resale activities of distributors underneath him in the pyramid in the form of commissions. Petitioners were distributors at the level of "coordinator," which is one of the highest distributors ranks on the pyramid.

The purchase price of the petitioners' distributorship was \$[redacted]. It was paid pursuant to the terms of a promissory note which provided for the payment, without interest, of monthly installments of \$[redacted]. The purchase agreement allocated the purchase price as follows: \$[redacted] for inventory, \$[redacted] for fixtures and equipment, and \$[redacted] for the distributorship rights and goodwill.

During the tax years at issue, [redacted], the petitioners paid \$[redacted] per month for a total expenditure of \$[redacted] per year. They deducted the \$[redacted] as an I.R.C. § 162 expense under the label "bonus paid." The petitioners also had previously deducted \$[redacted] in [redacted] and \$[redacted] in [redacted].

Petitioners concede that a section 162 deduction is inappropriate because the purchase price represented a capital expenditure. However, they contend that they are entitled to section 163 deductions of \$[redacted] annually for unstated interest and to section 167 amortization deductions for the value of the distributorship rights. Appeals has conceded that the deduction for unstated interest is appropriate under sections 483 and 163. The sole issue remaining, therefore, is the amortization issue.

DISCUSSION

To support their argument for amortization, petitioners rely on a number of customer-based intangible cases--Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974); Richard S. Miller & Sons v. United States, 537 F.2d 446 (Ct. Cl. 1976); Business Service Industries, Inc. v. Commissioner, T.C. Memo. 1986-86; Holden Fuel Oil v. Commissioner, 479 F.2d 613 (6th Cir. 1973); National Service Industries, Inc. v. United States, 379 F. Supp. 831 (N.D. Ga. 1973). A customer-based intangible is an intangible asset the value of which rests upon the expectation of continued customer patronage. For example, in Houston Chronicle, the taxpayer amortized the subscription list it had obtained in the acquisition of a competing newspaper. It valued the list based upon the estimated future subscription income from the customers on the list. Another defining characteristic of a customer-based intangible is that the customer relationships upon which its value rests are terminable-at-will relationships rather than contractual.

The "distributorship rights" intangible in the instant case is a customer-based intangible because its value rests upon continued sales by the marketing system. The distributors below the petitioners on the pyramid are the conduit through which the petitioners reach the customers. There are no contractual relationships in the pyramid which guarantee the petitioners any income. Accordingly, the customer-based intangible case law is relevant. However, the cases relied upon by the petitioners are distinguishable while other customer-based intangible cases are controlling.

Before examining the case law, reference should be made to Rev. Rul. 74-456, 1974-2 C.B. 65, which holds that except in an unusual circumstance, customer-based intangibles represent nonamortizable goodwill. In the unusual circumstance, however, a customer-based intangible is amortizable if the taxpayer can prove its value and useful life.

The revenue ruling does not indicate what an unusual circumstance might be. Nevertheless, the courts appear to have answered that question. The test developed by the Tax Court for determining whether a customer-based intangible is amortizable rests upon the definition of goodwill and upon whether a taxpayer attempts to preserve the customer structure of the acquired business.

The Tax Court has found that typically when a taxpayer/purchaser steps into a seller's shoes, it has preserved the seller's customer structure. See Finoli v. Commissioner, 86 T.C. 697 (1986). In such a case, the taxpayer is typically found to have purchased no more than nonamortizable goodwill, which has been defined as the expectancy of continued customer patronage, for whatever reason. See Boe v. Commissioner, 397 F.2d 339, 343 (9th Cir. 1962). "Stepping into the shoes" occurs when a taxpayer continues to operate the seller's business in substantially the same form. See Balthrope v. Commissioner, 356 F.2d 28, 32 n.1 (5th Cir 1966). In these cases, the value of the customer lists at issue were represented by the customer structure, which is simply the expectation of continued customer patronage, i.e., goodwill.

In General Television, Inc. v. United States, 449 F. Supp. 609 (D. Minn. 1978), aff'd per curiam, 598 F.2d 1148 (8th Cir. 1979), the court disallowed amortization deductions for a customer list acquired as part of a going concern. The court relied on the concept that the taxpayer simply acquired the seller's customer structure which is goodwill. The Tax Court utilized the same analysis in Finoli v. Commissioner, 86 T.C. 697 (1986). See also Westinghouse Broadcasting Co. v. Commissioner, 36 T.C. 912 (1961), aff'd on other issues, 304 F.2d 339 (9th Cir. 1962) (taxpayer purchased customer structure not individual spot announcement contracts); Skilken v. Commissioner, 420 F.2d 266

(6th Cir. 1969), aff'g 50 T.C. 952 (1968) (location contracts represented goodwill); Decker v. Commissioner, 864 F.2d 51 (7th Cir. 1988), aff'g T.C. Memo. 1987-388 (list of insurance expirations was part of goodwill of acquired business).

The importance of the concept of "stepping into the shoes" may also be inferred from cases where amortization was permitted because the taxpayer did not step into the seller's shoes. For instance, in Manhattan Co. of Virginia, Inc. v. Commissioner, 50 T.C. 78 (1968), acq., 1974-2 C.B. 3, the Tax Court permitted amortization of a customer list acquired by a laundry home pick-up and delivery service. The taxpayer acquired the seller's customer list and obtained a covenant not to compete; however, it did not purchase the seller's name, location, or any other tangible or intangible assets. The court stated that by not purchasing the seller's entire business, the taxpayer was not obtaining the seller's customer structure; it was merely obtaining the ability to contact the seller's customers in an attempt to win their patronage. The court, however, did recognize that the customer list did possess some goodwill, mostly because the customers on the list might become the taxpayer's customers for an indefinite time and may recommend the taxpayer to other future customers. The court made a 25% allocation of the customer list amount to goodwill because one of the major customers was a school. The students and/or faculty members living on the school's premises used the seller's service. Even though the individuals in residence at the school at the time the taxpayer purchased the list may leave the geographical area, new students and/or faculty members would take their places thereby producing an indefinite useful life for the taxpayer's association with the school.

A recent Tax Court case, ABCO Oil, Corp. v. Commissioner, T.C. Memo. 1990-40, follows the reasoning of Manhattan Co. ABCO Oil involved the purchase of a home delivery fuel oil distributorship. The taxpayer obtained the seller's customer card file, trucks, and storage facility. It also obtained a covenant not to compete from the seller and hired some of the seller's employees. It did not, however, use the seller's name or location. In fact, the seller retained its prior location in order to operate a different type of business. The taxpayer also repainted the seller's trucks, required the employees to wear its uniform, and gave customers receipts with its own name printed on them.

The court held that since the taxpayer did not purchase the business as a going concern, it did not principally intend to preserve the seller's customer structure. Thus the court found that the customer list was partially amortizable. In finding that 25% of the value of the list represented goodwill, the court noted that the taxpayer notified the seller's customers of the transaction and continued to use the seller's business phone

number. The Court stated that these actions indicate that the purchaser attempted to preserve the seller's customer structure to some extent. This case also illustrates the dichotomy between "going concern" cases and isolated purchases.

The cases relied upon by the petitioners fit within the latter category. National Service Industries v. United States, 379 F. Supp. 831 (N.D. Ga. 1973), is simply Manhattan Co. revisited. In National Service Industries, the taxpayer purchased a linen and towel laundry business under facts similar to those in Manhattan Co. The same is true of Holden Fuel Oil v. Commissioner, 479 F.2d 613 (6th Cir. 1973), in which the court noted that no goodwill was transferred; the taxpayers only guaranteed acquisition was the list of names, not the continued patronage. Holden Fuel Oil, 479 F.2d at 615. See also Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974) (subscription list held to be amortizable because purchased along with a business that was being discontinued).

In Richard S. Miller & Sons v. United States, 537 F.2d 446 (Ct. Cl. 1976), the taxpayer purchased insurance expirations. Again, this case did not involve the purchase of a going concern. The court stated that the transfer of an ongoing business was not the primary objective. The taxpayer did not use the seller's name, location, sales personnel, or office procedures. Moreover, the sales contract did not include office equipment, furniture, motor vehicles, or intangibles such as cash, notes, accounts receivables, or uncollected premiums. Richard S. Miller & Sons, 537 F.2d at 454. The implication from this opinion is that when an ongoing business is purchased, the "customer list" represents goodwill in the form of the business' customer structure. This conclusion was adopted by the Seventh Circuit in Decker v. Commissioner, 864 F.2d 51 (7th Cir. 1988), where the court held that insurance expirations represented goodwill in the context of the acquisition of a going concern.

The last case relied upon by the petitioners is Business Services Industries, Inc. v. Commissioner, T.C. Memo. 1986-86. In that case the taxpayer acquired a Muzak franchise. One of the assets acquired was the customer contracts, i.e., contracts to provide Muzak to the customers. The court permitted amortization even though the acquisition represented the purchase of a going concern. This case is distinguishable from the instant case because its contracts represented binding legal commitments as opposed to terminable-at-will relationships. See General Television, Inc. v. United States, supra (nonamortizable subscriber contracts distinguishable from amortizable player contracts because they were terminable-at-will).

There are two cases that fall outside of the "stepping into the shoes" pattern described above. In Donrey, Inc. v. United

States, 809 F.2d 534 (8th Cir. 1987), a jury determined that a newspaper subscription list acquired as part of an ongoing business was amortizable. On appeal, the three judge panel determined that the District Court acted properly in submitting the question to the jury and that the jury's determination was not clearly erroneous. The dissenting judge, however, agreed with the government that, as a matter of law, goodwill includes the subscription list. Thus, we maintain that Donrey was affirmed only on procedural grounds and that the dissenting judge was correct in stating that the District Court's failure to grant the government's motion for judgment notwithstanding the verdict should have been reversed.

The second case that falls outside of this pattern is Newark Morning Ledger Co. v. United States, No. 88-4836 HLS (USDC NJ Apr. 3, 1990). In Newark Morning Ledger, the court determined that the existing subscribers of acquired ongoing publications had limited useful lives and thus could be amortized. The court did not even couch the "intangible" in terms of subscription lists, but rather stated that the future income from the subscribers itself was the asset. We have recommended to the Department of Justice that this case be appealed.

Donrey and Newark Morning Ledger conflict with the established Tax Court precedent discussed above in that they contain the "stepping into shoes" fact pattern. Accordingly, they should not be dispositive of the instant Tax Court litigation.

In the instant case, the distribution rights represent the customer structure of the acquired pyramid. The distribution rights in essence are sales commissions from transactions with customers. By purchasing the pyramid, the petitioners expected the continued patronage of both the lower tier distributors and their customers. The purchase of the pyramid represented the purchase of an ongoing business in that the petitioners simply stepped into the seller's shoes. The operation of the pyramid did not change as a result of the acquisition.

The petitioners might argue that they did not purchase the pyramid with the intention of maintaining it indefinitely. Rather, they might argue that they purchased it for the income stream and planned to let it disintegrate by not replacing lower tier distributors as they leave. This point is evidenced by the fact that they lived in Indiana and the pyramid was in California.

These arguments bolster the petitioners' case factually. Nevertheless, the definition of goodwill is the expectation that the old customers will resort to the old place. Commissioner v. Killian, 314 F.2d 852, 855 (5th Cir. 1963). It is this expectation that the petitioners purchased. Moreover, the

petitioners' co-coordinators actively sought new lower-tier distributors, which rejuvenated the petitioners' pyramid.

It is clear that some allocation should be made to goodwill. However, there are litigating hazards in asserting that the entire value of the distribution rights represents goodwill. These hazards arise from the fact that this issue is not factually identical to customer list cases and it has never been the subject of litigation. Moreover, an opinion should have little precedential value. Accordingly, we suggest that you seek a settlement with the petitioners in which at least [REDACTED] of the value of the distribution rights is recharacterized as nonamortizable goodwill. Barring an acceptable settlement, however, we suggest you defend the case.

If you have any questions, contact Joan Rood at FTS 566-3442.

MARLENE GROSS

By:

Richard L. Carlisle

RICHARD L. CARLISLE
Senior Technician Reviewer
Branch No. 1
Tax Litigation Division